Supreme Court, U. S.
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In the Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-858

JOAN E. KIRKPATRICK,
Petitioner,

VERSUS

THE UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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November, 1979

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Joan E. Kirkpatrick prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit, entered in the above-entitled case on September 10, 1979.

CITATIONS TO OPINIONS BELOW

The opinion of the United States Court of Appeals for the Tenth Circuit is unreported and is printed in Appendix A hereto, *infra,* p. A-8. The opinion of the United States District Court for the Western District of Oklahoma, printed in Appendix A, hereto, *infra,* p. A-1, is reported in 449 F. Supp. 186.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on September 10, 1979. Rehearing was denied on October 4, 1979. A copy of the Order denying Rehearing is printed in Appendix A hereto. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

1. Has a tax exemption statute been so faultily construed so as to deny a Bond issued to finance a health care facility tax exempt status because the facility is being leased to doctors who contribute to the delivery of health care by the landlord hospital?

2. Can the United States Treasury Department, despite clear statutory language and expression of congressional intent, impose its policy considerations as a substitute in administering the Internal Revenue Code?

STATUTES INVOLVED

The statutory provisions involved are 26 U.S.C. §§ 103 (a), 103(b), 501(a), 501(c)(3), and 513(a). They are set out in Appendix B hereto.

STATEMENT OF THE CASE

The jurisdiction of the District Court was invoked under the provisions of 28 U.S.C. § 1346(a)(1), for the recovery of Internal Revenue taxes alleged to be erroneously, illegally and improperly assessed and collected from Joan E. Kirkpatrick.

I.

SYNOPTIC INTRODUCTION TO FACTS AND LEGISLATIVE HISTORY

A. *Facts.*

The Oklahoma Industries Authority issued Bonds having a face value of $5.3 million. The proceeds of the bond issue were used to erect a multi-story building adjacent to and connected to Mercy Hospital which is located some 18 miles Northwest of Downtown Oklahoma City, Oklahoma, in a sparsely settled area.

Oklahoma Industries Authority leased the building to Mercy Hospital for a term conterminous with the period within which the bonds would mature for a consideration equal to the debt service on said bond and the fundings of certain reserves.

Mercy Hospital, in turn, sub-leased space in the building to various entities supportive of the role of the hospital, *i.e.*, private physicians who serve on its staff, pharmacy, nurses uniform shop and similarly related services.

Joan E. Kirkpatrick purchased a portion of the bonds having a face value of $175,000.00. During the years in question, the Bond Indenture Trustee remitted to Joan Kirkpatrick the requisite interest accuring on the Bond. She excluded the interest from her gross income on the requisite form 1040 filed with the Internal Revenue Code.

The Internal Revenue Service, administratively construing the Congressional intent, assessed a deficiency. The deficiency was paid and this suit was brought to obtain a refund thereof.

B. *The Legislative History*

Section 103(a) of the Internal Revenue Code provides that gross income does not include interest on certain governmental obligations. This exclusion is popularly referred to as "tax exempt", *e.g.*, municipal bonds. This type of bond is also used to finance exempt hospital facilities.

In recent history, governmental sub-divisions began issuing bonds as a method of financing facilities for other public purposes, *i.e.*, local industries. The Congress responded by what is now § 103(b) by stating that interest on an industrial development bond, with certain exemptions, shall not be similarly excluded. An exemption for certain small issues up to $5,000,000 was in effect until the Revenue Act of 1978, when the "exempt small issue" lid was raised to $10,000,000. The Congress defined industrial development bond generally as one the proceeds of which are to be used directly or indirectly in any trade or business carried on by a *non-exempt person* and the payment of the principal or interest on which is secured by any interest in property used or to be used in a trade or business.

The Congress also very carefully defined "exempt person" so as to distinguish it from the "non-exempt person" which triggers the treatment of the obligation as an "industrial development bond."

Congress said that in order to be an exempt person so as to avoid the treatment of the issue as an industrial development bond, the "exempt person" must be, *inter alia*, a 501(c)(3) organization using the proceeds of the issue in a trade or business carried on by it which is related (as determined by applying § 513(a) of the Internal Revenue

Code) to the purposes for which the organization was granted its exemption under § 501(a) of the Internal Revenue Code. In other words, if the proceeds of the issue are being used by an exempt person in a related trade or business, § 103(b) [industrial development bond] does not apply and the issue derives its exemption from § 103(a).

II.
THE PROCEEDINGS IN THE COURTS BELOW

Since this case turns mostly on statutory construction, for sake of brevity many of the uncontroverted facts are omitted; however, suffice it to say that Mercy Hospital is an exempt organization under 26 U.S.C. § 501(c)(3) and an "exempt person" for purposes of 26 U.S.C. § 103(b)(3)(B). Further, for purposes of § 103(a) *supra*, Oklahoma Industries Authority qualifies as an issuer whose bonds are accorded § 103(a) treatment. The District Court found that the sub-leasing from Mercy Hospital of the part of the Tower, *i.e.*, office building, by non-exempt persons caused the bonds to be industrial development bonds [and did not qualify as an "exempt small issue" under the then $5 million lid] entitling the United States to a judgment as a matter of law. The District Court did not address directly the question of fact of whether the sub-leasing by Mercy Hospital was a related trade or business [which the taxpayer contended would remove the issue from § 103(b) treatment]. Among the admitted facts were that the pharmacy and uniform shop are essential and convenient to patients and nurses. The United States also admitted that there was no code provision or regulation under the Internal Revenue Code which *states* that the leasing by a

tax-exempt organization to a non-exempt person who contributes importantly to the accomplishment of the purpose for which the tax exemption is granted causes the tax-exempt organization to lose its status as an exempt person for purposes of determining the application of § 103(b)(1) to the Bonds. Moreover, in order to be a tenant of the building, a doctor must be a member of the medical staff of Mercy Hospital. The doctors and other tenants pay market rent. No sub-tenant, by virtue of its lease, can acquire title to the property. The hospital needs the facility to fulfill its public purpose.

The core of the argument of the United States is contained at page 13 of the Brief for the Appellee before the Circuit which stated:

> "The reference to §513 of the Code in the definition of an exempt person in §103(b)(3) which was relied upon by the taxpayer (Br. 17-19) was intended only to prevent an exempt organization from making direct use of tax exempt bond proceeds in the conduct of an *unrelated* trade or business by building the facility needed to operate such a business and servicing the bonds with the proceeds. It does not follow that Congress intended to permit the indirect use of tax exempt bond proceeds in the trade or business of a non-exempt lessee merely because, under the circumstances, the leasing activities of the exempt lessor were not an unrelated trade or business. The express statutory bar against direct or indirect use of such proceeds, as contained in §103(b)(2)(A) precludes any use of tax exempt bond proceeds, *even in a related trade or business*, where the ultimate user of the facilities in question is to be a non-exempt person." (Emphasis added.)

The Circuit Court, in sustaining the District Court in its granting of summary judgment, held:

> "Sections 501, 511, 512, and 513 pertain to the tax liability to Mercy on income received from an unrelated trade or business. We are not concerned with the tax liability of Mercy, but rather with the tax liability of income received from the bond issue of the authority . . . the reference in §103(b)(3)(B) to the application of §513 confuses the tax liability of Mercy with the status of the bonds . . ."

The fallacy of the foregoing quotations will be expanded in Reasons for Granting the Writ hereafter; however, it should be noted here that § 513 is not mentioned in § 103 for unrelated trade or business income purposes (hence, there is no confusion) and if the foregoing argument and holding were correct, there would be no need to carefully define "exempt person" or to mention § 513 in § 103(b).

REASONS FOR GRANTING THE WRIT

I.

BROAD PUBLIC INTEREST

The Court of Appeals has rendered a decision on an important question of Federal law which has not been, but should be, settled by this Court.

While Joan E. Kirkpatrick's monetary interest herein is relatively small, albeit important to her, the impact of the administrative lawmaking by the Treasury Department on health care delivery in the United States in terms of dollars, bricks and mortar and jobs is enormous. Further development of health care delivery facilities has been stifled by reason of the position of the Treasury herein and the decisions of the lower courts.

The Revenue Bond law is a very narrow field of law. The "103 Section" of the Office of the Commissioner of Internal Revenue is small. Each, however, play an important role in the financing for public purposes. The United States Treasury Department even has a Special Assistant to the Assistant Secretary for Tax Policy and a Tax Legislative Counsel. The alarming imposition of the will of the Treasury Department in substitution for that of Congress is demonstrated at page 11 of the Brief of the Appellee previously mentioned wherein the United States characterizes financing of hospital facilities as an abuse and as a conduit "for channeling into non-exempt businesses funds borrowed at favorable rates of interest . . ."

Moreover, the fallacy of the rationale of the United States is demonstrated in the quote on page 13 of the said Brief wherein the United States argues that § 103(b)(2)(A) precludes any use of tax exempt bond proceeds, even in a related trade or business, where the ultimate user of the facilities in question is to be a non-exempt person. The implication of the foregoing (as well as the direct statement made to this writer by a person in the "103 Section" during a conference in Washington, D.C., pursuant to a request by the District Office in Oklahoma City for technical advice pursuant to the appropriate Revenue Procedure steming from this factual situation) is that the bond proceeds herein would be exempt if the sub-tenant of Mercy Hospital had been an "exempt" person, *without any consideration of whether or not the leasing to such person contributed importantly to the purposes for which Mercy Hospital had been granted its tax exempt status under § 501(c)(3)*. Not only does such rationale ignore the clear mandate of § 103(b)(3)(B) [*i.e.*, whether or not the leasing is related] but also flies in the face of the regulations of the Treasury Department under § 513 which declare such an unrelated leasing as a source of unfair competition and place an unrelated business activity of certain exempt organizations upon the same tax basis as the non-exempt business endeavors with which they compete. So, unless the sub-tenant (exempt or non-exempt) contributes to the tax exempt function of the sub-lessor, the sub-leasing would be an unfair competition with private landlords.

Further illustrative of the conflict between the attitude of Congress and the over-zealous sheparding of the public treasury by the Treasury Department by erroneous and restrictive regulations tantamount to lawmaking is the fact that by the Revenue Act of 1978, Congress raised the limit for a small issue exemption from $5 million to $10 million. Oddly enough, were this an industrial development bond and issued after December 31, 1978, it would be blessed.

II.

ERROR IN THE COURTS BELOW IN STATUTORY CONSTRUCTION AND INTERPRETATION OF LEGISLATIVE INTENT

Aside from the erroneous view by the United States and the Court of Appeals of the role of § 513 in construing § 103(b), the legislative history exempting the Bonds herein from the definition of industrial development bonds has been overlooked. The conference committee report number 1533, 90th Congress 2d. Sess. pp. 13-166, states:

> "an 'exempt person' for purposes of the provision described above is a governmental unit or a tax-exempt religious, charitable, educational, etc., organization (ex-

empt by reason of §501(a) and 501(c)(3) of the Code). *In this latter case, however, the exempt organization is included only when it uses the proceeds of the bond issue in an activity which is not an unrelated trade or business as determined elsewhere under the tax laws* (this determination is to be made whether or not the particular organization may be subject to the unrelated business income tax).

The result of these exemptions for governmental units and certain exempt organizations is to exempt bond issues such as those issued by a state or local governmental unit to finance dormitory facilities for the tax-exempt educational institutions, or to finance hospital facilities for tax-exempt hospitals (charitable), *since bond issues for the use of specified types of exempt organizations are not included in the first element of the definition of Industrial Development Bonds . . .*

> . . . as does the Senate amendment providing for a tax on interest on Industrial Development Bonds, *the conference substitute also excepts bonds issued by governmental unit to provide facilities for certain exempt activities even though the activities are carried on by a private person in a trade or business.*" (emphasis added).

Not only did Congress carefully define "exempt person" but carefully explained why in the conference committee report.

> IF THE ACTIVITIES ARE EXEMPT, THEY MAY BE CARRIED ON EVEN BY PRIVATE PERSONS IN A TRADE OR BUSINESS.

Likewise, the Circuit Court cited in support of its opinion Example 8 in the Conference Committee Report which reads:

> "*Example 8* — Governmental Unit E issues an obligation to finance the construction of various facilities

> that are to be leased to numerous unrelated corporations for their use and their trades or businesses. The obligations are secured by revenues that Governmental Unit E will derive from such leases. The bonds will constitute Industrial Development Bonds notwithstanding the fact that the activities of Governmental Unit E, an exempt person, may amount to a trade or business of leasing property, since the property involved would be used by each of the corporations in their respective trades or businesses."
>
> (Please note that a "given" in the example does not include that the leasing was a *related* trade or a business.)

The court overlooked Example 7 which supports Joan Kirkpatrick's position:

> "*Example 7* — Governmental Unit D issues its obligations to finance the construction of dormitories for educational institution Y, which is an organization described in §501(c)(3) of the Code and exempt from tax under §501(a) of the Code. The dormitories are to be owned and operated by Y and *do not constitute an unrelated trade or business.* The bonds are not Industrial Development Bonds since the proceeds are not to be used in a trade or business by a person who is not an exempt person." (emphasis added.)

Please note that one of the "givens" in Example 7 is that the operation of the dormitories constitutes a related trade or business, *i.e.*, it is an exempt activity. By analogy, the operation of the office building of the hospital, if it contributes importantly to the purpose for which the exemption has been granted and therefore a related trade or business is an exempt activity rendering § 103(b) [industrial development bond] inapplicable thereto.

CONCLUSION

For the foregoing reasons, the least relief to which the taxpayer is entitled is a hearing on whether or not the leasing of the office building contributes importantly to the purposes for which Mercy Hospital was granted a tax exemption under § 501(c)(3). Accordingly, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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Counsel for Petitioner

November, 1979

CERTIFICATE OF SERVICE

I, William J. Robinson, Attorney for Petitioner herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on this 30th day of November, 1979, I served three (3) copies of the foregoing Petition for Writ of Certiorari on the following named counsel for Respondent:

Solicitor General
Department of Justice,
Tenth and Constitution
Washington, D.C. 20530

Attorney General
Department of Justice
Tenth and Constitution
Washington, D.C. 20530

Robert S. Pomerance
M. Carr Ferguson
Gilbert E. Andrews
Tax Division
Department of Justice
Tenth and Constitution
Washington, D.C. 20530

by placing same in the United States Mail postage fully prepaid. per US Sup. Ct. Rules 1, 2(a) & 3(b)

William J. Robinson

APPENDICES

APPENDIX A

IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF OKLAHOMA

[Filing stamp omitted in printing]

JOAN E. KIRKPATRICK, Plaintiff,	)	
-vs-	)	No. CIV-77-0511-D
UNITED STATES OF AMERICA, Defendant.	)	

ORDER GRANTING SUMMARY JUDGMENT

This is an action for a tax refund in which Plaintiff seeks recovery of income taxes alleged to have been erroneously, illegally and improperly assessed and collected from Plaintiff. It is asserted that the Court has subject matter jurisdiction of this action pursuant to 28 U.S.C. § 1346(a)(1).

Pursuant to Rule 56, Federal Rules of Civil Procedure, Plaintiff has filed herein a Motion for Summary Judgment and a Brief in support thereof. Defendant has filed a Cross-Motion for Summary Judgment and supporting Brief to which Plaintiff has responded.

From the record before the Court in this case it appears without dispute that certain bonds known as "Oklahoma Industries Authority, First Mortgage Gross Revenue Bonds 1973, Mercy Hospital Building Series" (Bonds) in the principal amount of $5,300,000.00 were issued by the Oklahoma Industries Authority (Authority) and Plaintiff purchased $175,000 worth of the Bonds. All or a major portion of the proceeds from the sale of the Bonds were used to construct and furnish a professional office building, Mercy Doctors Tower (Tower), located adjacent to Mercy Hospital in Oklahoma City. The Tower was leased to Mercy Hospital by the Authority. Prior to July 22, 1977, Mercy Hospital as lessor, or its agent acting on its behalf,

had entered into twenty-five subleases covering all of the office space in the Tower ready for occupancy which amounted to twenty-nine per cent of the Tower's total leasable floor space.

Plaintiff did not report the interest she received from the Bonds as part of her gross income for the tax years 1973 and 1974 and tax deficiencies were later assessed against her in the amount of $3,320.00 for 1973 and $6,-651.00 for 1974. Plaintiff paid these assessments and brought this action seeking to recover $9,971.00 plus interest and attorney's fees.

In support of her Motion for Summary Judgment, Plaintiff contends that interest on the Bonds is not included as gross income under 26 U.S.C. §103[1] as Mercy Hospital is an "exempt person" within the meaning of 26 U.S.C. §103(b)(3)(B); that the leasing of the Tower to the subtenants by Mercy Hospital is not a trade or business carried on by it which is an unrelated trade or business; that the subtenants of the Tower contribute importantly to the accomplishment of the purpose for which Mercy Hospital was granted a tax exemption under 26

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[1] The portion of 26 U.S.C. §103 pertinent to this case is as follows:

"(a) *General rule.*—Gross income does not include interest on—

(1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia; and

(2) qualified scholarship funding bonds.

(b) *Industrial development bonds.*—

(1) *Subsection (a)(1) or (2) not to apply.*—Except as otherwise provided in this subsection, any industrial development bond shall be treated as an obligation not described in subsection (a)(1) or (2).

(2) *Industrial development bond.*—For purposes of this subsection, the term 'industrial development bond' means any obligation—

(A) which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is

[Footnote continued next page]

U.S.C. §501(a); and that the proceeds of the Bonds are being used directly or indirectly in the trade or business of Mercy Hospital. Defendant contends that the Bonds are industrial development bonds within the meaning of 26 U.S.C. §103(b) and therefore the interest on the Bonds is taxable as all or a major portion of the proceeds from the sale of the Bonds were used to construct, expand and/or furnish the Tower and all of the subtenants of the Tower are non-exempt persons within the meaning of 26 U.S.C. §§103(b)(2)(A) and 103(b)(3).

Rule 56, Federal Rules of Civil Procedure, provides in part:

> "(c) *Motion and Proceedings Thereon.* . . . The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."

---

[1] (Continued)

not an exempt person (within the meaning of paragraph (3)), and

(B) the payment of the principal or interest on which (under the terms of such obligation or any underlying arrangement) is, in whole or in major part—

(i) secured by any interest in property used or to be used in a trade or business or in payments in respect of such property, or

(ii) to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

(3) *Exempt person.*—For purposes of paragraph (2)(A), the term 'exempt person' means—

(A) a governmental unit, or

(B) an organization described in section 501(c)(3) and exempt from tax under section 501(a) (but only with respect to a trade or business carried on by such organization which is not an unrelated trade or business, determined by applying section 513(a) to such organization)."

A summary judgment is a drastic action available only in a case where there are no material issues of fact and a formal trial would be fruitless. *Webbe* v. *McGhie Land Title Co.*, 549 F.2d 1358 (Tenth Cir. 1977); *Frey* v. *Frenkel*, 361 F.2d 437 (Tenth Cir. 1966). A Motion for Summary Judgment should be granted only when the moving party has established the absence of any genuine issue as to a material fact. *Williams Petroleum Co.* v. *Midland Cooperatives, Inc.*, 539 F.2d 694 (Tenth Cir. 1976); *Dzenits* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168 (Tenth Cir. 1974); *James* v. *Atchison, Topeka and Santa Fe Railway Co.*, 464 F.2d 173 (Tenth Cir. 1972). The Court must examine the summary judgment papers in the light most favorable to the party opposing the Motion. *Adickes* v. *S.H. Kress & Co.*, 398 U.S. 144, 90 S.Ct. 1598, 26 L.Ed.2d 142 (1970); *National Aviation Underwriters* v. *Altus Flying Service, Inc.*, 555 F.2d 778 (Tenth Cir. 1977); *Webb* v. *Allstate Life Insurance Co.*, 536 F.2d 336 (Tenth Cir. 1976); *Frey* v. *Frankel, supra.* All the ambiguities and disagreements must be resolved in favor of the party against whom summary judgment is sought. *Webb* v. *Allstate Life Insurance Co., supra.* The Court must consider factual inferences tending to show triable issues in the light most favorable to the existence of such issues and summary judgment must be denied unless the movant demonstrates his entitlement to it beyond a reasonable doubt. *National Aviation Underwriters* v. *Altus Flying Service, Inc., supra; Mustang Fuel Corp.* v. *Youngstown Sheet & Tube Co.*, 516 F.2d 33 (Tenth Cir. 1975). And where different ultimate inferences may properly be drawn, the case is not one for summary judgment. *United States* v. *Diebold*, 369 U.S. 654, 82 S.Ct. 993, 8 L.Ed.2d 176 (1962); *Webb* v. *Allstate Life Insurance Co., supra.*

The Court has examined the pleadings, depositions, answers to interrogatories, admissions and affidavits on file herein and concludes that no genuine issue as to any material fact exists in this case. In response to Request Number 1 of Defendant's First Set of Requests for Admissions, Plaintiff admitted that all or a major portion of the proceeds from the sale of the Bonds were applied, or otherwise spent in connection with, the construction, expansion and/or furnishing of the Tower. Plaintiff responded to Interrogatory Number 1(a) of Defendant's First Set of Interrogatories by stating that none of the subtenants of the Tower are or have been organizations described in 26 U.S.C. §501(c)(3) which are exempt from tax under 26 U.S.C. §501(a). In response to Request Number 3 of Defendant's First Set of Requests for Admissions, Plaintiff admitted that none of the tenants occupying the Tower were governmental units. Plaintiff and Defendant have stipulated in the Pretrial Order filed herein on October 20, 1977, that the payment of the principal and interest on the Bonds is, in whole or in major part, to be derived from payments in respect of property, namely the Tower. Therefore, in order for the Court to hold that the Bonds are industrial development bonds, the Court must find that the "dual use" of the Tower (i.e. the leasing of the Tower to and by Mercy Hospital and the subleasing from Mercy Hospital of part of the Tower by non-exempt persons) constitutes the use of all or a major portion of the proceeds of the Bonds directly or indirectly in any trade or business carried on by a non-exempt person.

The Conference Committee Report of the Congress which enacted the industrial bond development provision states in part:

> "[I]f all or a major portion of the proceeds of an issue . . . are to be used to construct facilities to be leased to *any* person who will in turn lease them to another person who is not an exempt person for use in a trade or business carried on by him, such proceeds are to be used in a trade or business carried on by a person who is not an exempt person and the obligations comprising such issue are industrial development bonds." Conf. Rep. No. 1533, 90th Cong., 2d Sess.,

reprinted in [1968] U.S. Code Cong. & Ad. News 2373 at 2381 (Emphasis added).

The above passage makes it clear that Congress intended that bonds whose proceeds were used to build facilities to be leased to *any* person, whether exempt or not, who in turn leased them to non-exempt persons would constitute industrial development bonds. In the instant case, the record before the Court clearly establishes that the Tower was built with the proceeds of the Bonds and leased to Mercy Hospital; an exempt person. Mercy Hospital later subleased twenty-nine per cent of the floor space of the Tower, which was all of the space that was ready for occupancy, to non-exempt persons.

In view of the foregoing, the Court finds and concludes that a major portion of the proceeds from the Bonds are being used directly or indirectly in the trade or business of non-exempt persons,[2] the subtenants of the Tower, and that the payment of the principal and interest of the Bonds is being derived from payments in respect of property used in a trade or business. Therefore, the Bonds are industrial development bonds within the meaning of 26 U.S.C. §103 (b) (2) and the interest thereon is to be included as gross

[2] Treas. Reg. §1.103-7(b)(3)(iii) (1972) provides in part as follows:

> "The use of more than 25 percent of the proceeds of an issue of obligations in the trades or businesses of nonexempt persons will constitute the use of a major portion of such proceeds in such manner. In the case of the direct or indirect use of the proceeds of an issue of obligations or the direct or indirect use of a facility constructed, reconstructed, or acquired with such proceeds, the use by all nonexempt persons in their trades or businesses must be aggregated to determine whether the trade or business test is satisfied. If more than 25 percent of the proceeds of a bond issue is used in the trades or businesses of nonexempt persons, the trade or business test is satisfied."

Therefore, as twenty-nine per cent of the Tower is occupied by non-exempt persons, the twenty-five per cent requirement of the above regulation has been satisfied in the instant case.

income for income tax purposes. Accordingly, Defendant is entitled to a judgment as a matter of law.

As there is no genuine issue as to any material fact herein and Defendant is entitled to a judgment as a matter of law, Defendant's Cross-Motion for Summary Judgment should be granted and Plaintiff's Motion for Summary Judgment should be overruled and this action dismissed.

It is so ordered this 21 day of February, 1978.

(s) *Fred Daugherty*
Fred Daugherty
United States District Judge

[Filing stamp omitted in printing]

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

JOAN E. KIRKPATRICK,
Appellant,

v.

UNITED STATES OF AMERICA,
Appellee.

No. 78-1186

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF OKLAHOMA
(D.C. No. 77-0511-D)

William J. Robinson (Shirk, Work, Robinson & Williams, with him on the briefs) for Appellant.

Robert S. Pomerance (M. Carr Ferguson, Assistant Attorney General, Gilbert E. Andrews, Richard W. Perkins and Michael J. Roach, Attorneys, Tax Division, Department of Justice; Larry Patton, United States Attorney, with him on the brief) for Appellee.

Before SETH, Chief Judge, BREITENSTEIN and McKAY, Circuit Judges.

BREITENSTEIN, Circuit Judge.

In this taxpayer's suit for refund of federal income taxes the issue is whether interest income from bonds issued by the Oklahoma Industries Authority is taxable income. The district court so held and granted summary judgment for the United States. Kirkpatrick v. United States, W.D.Okl., 449 F.Supp. 186. We affirm.

Oklahoma Industries Authority, an agency of the State of Oklahoma, issued $5,300,000 principal amount "First Mortgage Gross Revenue Bonds." Plaintiff-appellant purchased $175,000 of these bonds and, on her 1973 and 1974 federal income tax returns, did not include as gross income the interest which she received from the bonds. The Commissioner of Internal Revenue assessed deficiencies of $9,971, which the taxpayer paid. She filed a claim for refund and, after its denial, sued in the Western District of Oklahoma for refund.

Proceeds from the bond issue were used to construct a professional office building, Mercy Doctors Tower, adjacent to Mercy Hospital. The Tower was leased to Mercy, a tax exempt organization. See 26 U.S.C. §501(c)(3). Beginning in October, 1973, Mercy subleased space in the Tower to a variety of tenants, including doctors, a medical laboratory, a sandwich shop, a pharmacy, an optician, and a dress shop. By December, 1977, 29% of the leaseable space, all of the Tower space then available for occupancy, had been subleased. 449 F.Supp. at 189. None of the subtenants were exempt from federal income tax.

After discovery, each party moved for summary judgment. The district court held that no material issues of fact were presented and granted summary judgment for the United States. In so ruling the court concluded that the bonds were industrial development bonds because a major portion of the proceeds were used in the trade or business of nonexempt persons, the subtenants of Mercy. This appeal questions the validity of that ruling.

Section 103(a)(1), 26 U.S.C., provides that gross income does not include interest on the obligations of a state or of one of its political subdivisions. A 1968 Act, now codified as 26 U.S.C. § 103(b)(1), provides that an industrial development bond shall be treated as an obligation, the interest on which is taxable. Section 103(b) establishes two tests, both of which must be met, for determining

whether an obligation is an industrial development bond. Subparagraph (2)(A) creates a trade or business test which is met by an obligation, the major portion of the proceeds of which "are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person." Subparagraph (2)(B) provides a security interest test which is satisfied if payment of the bond principal and interest is secured or derived from property in a trade or business. In the instant case, the security test is met and the question relates to the trade or business test.

Application of the test requires determination of the meaning of (1) "exempt person" and (2) "major portion." We consider first "exempt person." The term is defined in § 103(b)(3)(B) as

> "an organization described in section 501(c)(3) and exempt from tax under section 501(a) (but only with respect to a trade or business carried on by such organization which is not an unrelated trade or business, determined by applying section 513(a) to such organization)."

The unrelated business concept comes from § 511(a)(1) which imposes a tax "on the unrelated business taxable income" of an organization described in section 501(c)(3). See § 511(a)(2). The phrase "unrelated business taxable income" is defined by § 512(a) to mean "the gross income derived by any organization from any unrelated trade or business (as defined in section 513)." That section in its subparagraph (a) defines "unrelated trade or business" as "any trade or business the conduct of which is not substantially related * * * to the exercise or performance by such organization of its * * * function" exempting it from taxation under § 501. Treas. Reg. 1.513-1(d)(2), 26 CFR, says that "substantially related" means that there must be a substantial causal relationship of the business activities to the exempt purpose.

Sections 501, 511, 512 and 513 pertain to the tax liability of Mercy on income received from an unrelated trade or business. We are not concerned with the tax liability of Mercy, but rather with the taxability of income received from the bond issue of the Authority. That depends on whether the bonds are industrial development bonds within the purview of § 103(b)(2)(A). The reference in § 103(b)(3)(B) to the application of § 513 confuses the tax liability of Mercy with the status of the bonds, but is for the purpose of determining who is "an exempt person." The government concedes that Mercy is an exempt person.

Taxpayer argues that the "exempt person" provision of that section applies only to Mercy. The government contends that the provision applies to Mercy's subtenants. We agree with the government. Consideration of § 103 together with §§ 501 and 513 convinces us that the intent of the 1968 amendment was to assure that an exempt organization could not be used as a conduit to enable nonexempt persons to receive benefits arising from the use of bond proceeds in their trades and businesses. The legislative history of the 1968 amendments shows this intent.

The Conference Committee Report on what is now § 103(b)(2) says, Conf. Rep. No. 1533, 90th Cong. 2d Sess., 1968 U.S. Code Cong. & Admin. News, p. 2373, 2381, that under § 103(b)(2)(A) an obligation is an industrial development bond if all or a major portion of its proceeds

> "are to be used to construct facilities to be *leased to any person who will in turn lease them to another person* who is not an exempt person for use in a trade or business carried on by him * * *." [Underlining supplied.]

This is followed, Id., by the statement that when the bond proceeds "are to be used directly or indirectly in any trade or business carried on by *any* person who is not an exempt person," the obligations are industrial bonds "un-

less all or a major portion of such proceeds are to be used directly or indirectly only in a trade or business carried on by a person who is an exempt person, *and* are not to be used in *any* trade or business carried on by *any* person who is not an exempt person." [Underlining supplied.] See also Example 8 which follows. Id. at 2383.

The proceeds from the bonds in question were used to construct facilities which were leased to Mercy which in turn leased them to nonexempt persons for use in their activities. Mercy was the conduit which permitted nonexempt persons to benefit from the use of the bonds proceeds. We have exactly the situation which Congress intended to prevent.

Taxpayer's reliance on Treas.Reg. 1.103-7(b)(2) is misplaced. The reference there to an "exempt person" applies only to Mercy which is admittedly exempt. Of more importance is Treas. Reg. § 103-7(b)(3)(ii), 26 CFR, which says that when bond proceeds are to be used to construct facilities to be leased to an exempt person who will lease to a nonexempt person for use in a trade or business, the obligation is an industrial development bond.

Taxpayer cites Rev.Rul. 69-463, C.B. 1969-2, p. 131, which was concerned with § 513 of the 1954 Internal Revenue Code, not with the 1968 amendments relating to industrial development bonds. The question related to the activities of the hospital in performance of its contract with a medical group. The ruling was that the hospital's performance of its contract was not an unrelated trade or business and therefore did not remove its tax exemption under § 501(c)(3).

Of more significance is Rev.Rul. 77-352, C.B. 1977-2, pp. 34-35. It holds that bonds issued to construct an office building owned by a hospital and leased primarily for individual and private practice of doctors who are not hospital employees but who are affiliated with the hospital will be industrial development bonds.

Mercy's subtenants are not exempt persons. Hence, the use of proceeds from the Authority bonds in the activities of the subtenants makes the bonds industrial development bonds within § 103(b)(2)(A) if a major portion of the bond issue is used in the trades or businesses of those persons. We turn to that question, Treas.Reg. 1.103-7(b)(3)(iii) says:

> "The use of more than 25 percent of the proceeds of an issue of obligations in the trades or businesses of nonexempt persons will constitute the use of a major portion of such proceeds in such manner."

Taxpayer argues that the 25% test is not met because during 1973 and 1974, the taxable years in question, the occupancy by nonexempt persons was, at the most, 6.17%. The court found that the subleases in 1977 amounted to 29% of the total space and included all space then available for occupancy. 449 F.Supp. at 189. Taxpayer would have taxability of income from the bond issue fluctuate from year to year in accordance with the percentage of space then occupied by nonexempt persons. Section 103(b)(2)(A) contemplates no such impractical result. It refers to a bond issue, the proceeds from which "are to be used" in a trade or business of a nonexempt person. The language speaks to the future. The tenancy of the Tower in 1977 shows an original intent to use the space for nonexempt persons. We reject the taxpayer's fluctuating approach with its attendant and continuing uncertainties.

Taxpayer argues that summary judgment should not have been granted because a fact issue existed of whether Mercy's subleasing activities constituted a trade or business unrelated to Mercy's exempt functions. We do not agree. The material facts are not disputed. The relationship of the activities to the exempt functions may be pertinent to the tax liability of Mercy but that is of no concern to us. We have the legal question of whether the undisputed facts bring the Authority's bond issue within the statutory defi-

nition of industrial development bonds. The related statutes considered as a whole, the expressed legislative intent, and the administrative construction convince us that the bonds are industrial development bonds, the interest on which must be included in the gross income of the taxpayer.

Affirmed.

SEPTEMBER TERM — OCTOBER 4, 1979

Before Honorable Oliver Seth, Chief Judge, Honorable Jean S. Breitenstein, Honorable Monroe G. McKay, Circuit Judges.

JOAN E. KIRKPATRICK, Plaintiff-Appellant,	)	
vs.	)	No. 78-1186
UNITED STATES OF AMERICA, Defendant-Appellee.	)	

This matter comes on for consideration of appellant's petition for rehearing filed in the captioned cause.

Upon consideration whereof, the petition for rehearing is denied.

HOWARD K. PHILLIPS, Clerk

By (s) *Robert L. Hoecker*
Robert L. Hoecker
Chief Deputy Clerk

[Certification, Seal, etc. omitted]

APPENDIX B

26 U.S.C. § 103 (a) and (b)

§ 103. *Interest on certain governmental obligations*

(a) *General rule.*—Gross income does not include interest on—

(1) the obligation of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia; and

(2) qualified scholarship funding bonds.

(b) *Industrial development bonds.*—

(1) Subsection (a) (1) or (2) not to apply.—Except as otherwise provided in this subsection, any industrial development bond shall be treated as an obligation not described in subsection (a) (1) or (2).

(2) Industrial development bond.—For purposes of this subsection, the term "industrial development bond" means any obligation—

(A) which is issued as part of an issue all or major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person (within the meaning of paragraph (3)), and

(B) the payment of the principal or interest on which (under the terms of such obligation or any underlying arrangement) is, in whole or in major part—

(i) secured by any interest in property used or to be used in a trade or business or in payments in respect of such property, or

(ii) to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

(3) *Exempt person.*—For purposes of paragraph (2)(A), the term "exempt person" means—

(A) a governmental unit, or

(B) an organization described in section 501(c)(3) and exempt from tax under section 501(a) (but only with respect to a trade or business carried on by such organization which is not an unrelated trade or business, determined by applying section 513(a) to such organization).

* * * *

26 U.S.C. § 501(a)

§ 501. *Exemption from tax on corporations, certain trusts, etc.*

(a) *Exemption from taxation.*—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

* * * *

26 U.S.C. § 501(c)(3)

(c) *List of exempt organizations.*—The following organizations are referred to in subsection (a):

* * * *

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if not part of its activities involve the provision of

athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

* * * *

26 U.S.C. § 513(a)

§ 513. *Unrelated trade or business*

(a) *General rule.*—The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)), except that such term does not include any trade or business—

(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) which is carried on, in the case of an organization described in section 501(c)(3) or in the case of a college or university described in section 511(a)(2)(B), by the organization primarily for the convenience of its members, students, patients, officers, or employ-

ees, or, in the case of a local association of employees described in section 501(c)(4) organized before May 27, 1969, which is the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual place of employment; or

* * * *